QUESTION 1 **50 marks**

Ignore value-added tax.
Unless indicated otherwise, assume that all entities are Zimbabwean residents for taxation purposes.

1 Background

Kubanda (Pvt) Ltd ('Kubanda') was formed five years ago by a group of Zimbabwean entrepreneurs who wanted to manufacture local appliances that were affordable to the broader population of Zimbabwe. Kubanda now produces domestic fridges, called Solarcold; this is the only product produced by the company. Kubanda sells the Solarcold fridges to retail distributers at ZWL4 000 per fridge. Solarcold is labelled a 'proudly Zimbabwean product'. The company has a 30 June financial year end.

2 Production inputs and materials

The production process of the Solarcold fridges consists of a number of integrated steps that require various materials and inputs:

2.1 The external shell of the fridge is made from inexpensive steel sheeting that currently costs ZWL20 per square metre (m^2) and which can be cut and shaped in five minutes. The external shell of a Solarcold fridge uses 5 m^2 of steel sheeting. Kubanda had 500 m^2 of steel sheeting on hand on 30 June 2020 and it has ordered another 1 000 m^2 from a supplier. This has not yet been delivered and Kubanda has not yet paid for it either. All orders can be cancelled at a cancellation fee of 10% of the purchase price.

2.2 The inner cabinet is made from high-quality thin stainless steel and each fridge uses 4,5 m^2 of stainless steel. The cost of stainless steel sheeting is currently ZWL40 per m^2. Kubanda had 2 000 m^2 of stainless steel on hand on 30 June 2020 that could be resold at only 60% of its original cost as there is little demand for this material in the external market.

2.3 Both the inner cabinets and the external shells are sprayed with a white, quick-drying paint. Paint, sufficient to meet one month's production requirements, is purchased from Cha Paints, a Ruwa-based paint manufacturer, at ZWL40 470 per month. After spraying, the inner cabinet is placed in the external shell and low-density foam is sprayed into the gap between the cabinet and the shell to bind them together, thus forming the fridge case.

2.4 A cooling system with a high energy-efficiency rating is installed in the fridge. This feature makes Solarcold a unique domestic fridge. Kubanda did not have the funds to patent the design of the cooling system and therefore sources these systems from a local manufacturer, CS Ltd ('CS'). In terms of the agreement between Kubanda and CS, the system is specially designed to Kubanda's specifications and CS may not share the design or produce the systems for any other customers.

2.5 A Solarcold fridge is powered by solar energy and hence each fridge has two solar panels, an inverter and batteries. The batteries can power the fridge for four hours once fully charged. SolarZim (Pvt) Ltd supplies the solar panels, batteries and inverters as a 'solar set' at a cost of ZWL1 650 per set per fridge, which includes a delivery cost of ZWL10 per solar set. The minimum order is a batch of 500 solar sets. Kubanda does not currently have any solar sets on hand.

2.6 The last step in the process consists of the addition of accessories (e.g. shelves and ice trays), after which the fridge goes through a testing process. Accessories are bought from a local plastics producer at ZWL100 per set per fridge.

3 Production process and costs

Kubanda operates from a factory that is located in a business park in Harare. It is divided into two separate sections: one section is used as a metal processing plant and the other section is used for the assembly of the solar set and accessories of the fridge. The metal processing plant comprises metal shaping and cutting as well as paint-spraying machinery. A new and unused metal processing plant was purchased on 1 December 2018 for an amount of ZWL2,5 million and was brought into use on the same day. The plant has a useful life of five years and a residual value of ZWL100 000.

Normal production in the factory is 2 850 Solarcold units per month and the monthly costs of running the factory amount to ZWL343 030. The breakdown of the monthly costs are as follows:

Cost description	Note	ZWL
Supervisor salary	1	30 000
Plant operating staff salaries	1	120 000
Assembly staff wages	1	25 000
Maintenance and consumables	2	17 980
Rent	3	50 000
Electricity	4	100 050

Notes

1 There is one supervisor who oversees the production process and six staff members who operate the machinery at the metal processing plant. There are two unsupervised staff members who assemble all the components (e.g. the cooling system, solar sets and accessories) of the fridges. The employment conditions of all the staff members provide that, if a staff member is retrenched, he or she must receive a minimum retrenchment payment of six months' salary.

2 The machinery in the metal processing plant requires regular maintenance checks; if parts are not placed correctly, or cutting edges are not sharp, there is a risk that a whole batch of materials may be wasted. Consumables relate to welding, pop rivets and screws used in the metal processing plant only.

3 The factory rent amounts to ZWL50 000 per month and is allocated equally to each of the plant and assembly sections. The lease agreement is flexible and can be altered to suit the needs of Kubanda.

4 Each of the two factory sections uses a fixed amount of ZWL3 000 in electricity per month and, in addition thereto, on average the manufacturing of each Solarcold unit consumes 20 kiloWatt hours (kWh) at ZWL1,65 per kWh.

4 Business operations

Kubanda was unable to manufacture any fridges during the full lockdown period resulting from Covid-19, because fridges were classified as non-essential products. While Kubanda was able to negotiate extended payment terms from 20 to 40 days with its suppliers, orders from customers were being cancelled because of the economic downturn. This had a negative effect on the company's liquidity.

CS, Kubanda's supplier of cooling systems, was also struggling with low margins on other products because of competition from foreign suppliers. On 30 April 2020, CS notified Kubanda it was shutting down its company because of financial difficulties and that it had 1 500 cooling systems available, which it was willing to sell at ZWL708 each. This amount was equal to 80% of the retail price at that time. CS also told a Kubanda representative that it would need cash funding or a cash guarantee of ZWL5 million to settle its creditors if it were to wind down its other operations and produce cooling systems only.

As a result, Kubanda started searching for alternative sources of cooling systems. It approached foreign companies. One of these was Leng, a company based in China that manufactures fridge cooling systems for the Chinese market. Leng is not a resident for tax purposes. Leng offered to supply Kubanda with cooling systems at ZWL799 each, provided that Kubanda agreed to purchase a minimum of 2 850 cooling systems per month.

5 Sources of funding and restructure

Kubanda desperately needed cash to alleviate its liquidity challenges and started investigating possible sources of funding. It managed to conclude the following transactions:

5.1 A revolving credit facility with Green Bank of up to ZWL300 000 at the prime lending rate.

5.2 The sale of shares Kubanda owned in Avion Ltd ('Avion'), a company listed on the Zimbabwe Stock Exchange, for ZWL240 000 on 1 May 2020. The share price had declined significantly in the first quarter of FY2020.

Kubanda had acquired these shares on 1 September 2019 as a long-term investment. The purchase price of ZWL1 million had been funded with a loan that was obtained from Medupi (Pvt) Ltd ('Medupi'), an associated person in relation to Kubanda. The loan bore interest at 7% per annum and was payable annually in arrears.

After the sale of the shares in Avion, Kubanda and Medupi reached an agreement on 1 May 2020 that Kubanda would settle the outstanding loan and interest by transferring ownership of its delivery truck to Medupi. On 1 May 2020, the truck's market value was ZWL1,1 million. Kubanda had purchased the truck five years previously for ZWL4 million and it had been fully written off for tax purposes. Medupi, which does not lend money as its core business, has a 30 June year end.

5.3 Kubanda reached an agreement with its major controlling shareholder, Kusile (Pvt) Ltd ('Kusile'), relating to the provision of a shareholders' loan.

Kubanda and Kusile entered into a loan agreement on 1 July 2018 whereby Kusile agreed to provide a loan of ZWL5 million, which was used to purchase machinery. The loan was used to fund the purchase of new machinery necessary for the future expansion of operations. The loan had an interest rate of 6% per annum, which was payable quarterly in arrears.

Although the original repayment terms were five annual instalments, no payments of any amount had been made in respect of this loan. The board of directors of Kusile took a commercial decision to write off 60% of the original loan capital on 30 June 2020. The remainder of the debt is still outstanding. Kusile does not ordinarily engage in the business of moneylending. Kusile has a 30 June year end.

6 Alternative outsourcing options

Kubanda also considered the possibility of selling its plant on 30 June 2020 for a cash injection into the company. It could outsource parts of its production process to Metalwork AG ('Metalwork'). Metalwork (a non-resident for tax purposes) is based in Germany and manufactures metal formworks for several industries and companies across the world. Metalwork quoted Kubanda ZWL350 per fridge case. It would in addition charge delivery costs of ZWL3 000 per batch of 1 000 fridge cases. The minimum order would be 1 000 fridge cases and Metalwork would be able to supply up to 15 000 fridge cases per month. Time from order to arrival would be three weeks. Kubanda would have to pay for orders upfront.

If Kubanda outsourced the metal processes of the Solarcold fridges to Metalwork, it would be able to sell its plant for ZWL1 740 000.

INITIAL TEST OF COMPETENCE, APRIL 2021

PROFESSIONAL PAPER 1

PAPER 1 QUESTION 1 – REQUIRED		**Marks**	
		Sub-total	**Total**
(a)	(i) Calculate the capital gain or capital loss (if any) resulting from the sale of shares in Avion for Kubanda for the 2020 year of assessment	4	
	(ii) Discuss, with calculations where relevant, the impact of the settlement of the loan from Medupi on Kubanda's taxable income for the 2020 year of assessment.	4	8
(b)	Discuss, with calculations where relevant, the income tax consequences for Medupi of the loan settlement (including any interest owing) with Kubanda for the 2020 year of assessment.	7	
	Communication skills – presentation	*1*	8
(c)	Discuss the income tax consequences for Kusile and Kubanda with regard to the loan advanced to Kubanda as well as its partial write-off during its 2020 year of assessment.	5	5
(d)	Evaluate Kubanda's opportunity to purchase cooling systems from Leng, if Kubanda would no longer be able to purchase systems from CS.	9	
	Communication skills – logical argument	*1*	10
(e)	Determine, with supporting calculations, whether the production of fridge cases should be outsourced to Metalwork for FY2021.	18	
	Communication skills – presentation	*1*	19
Total			**50**